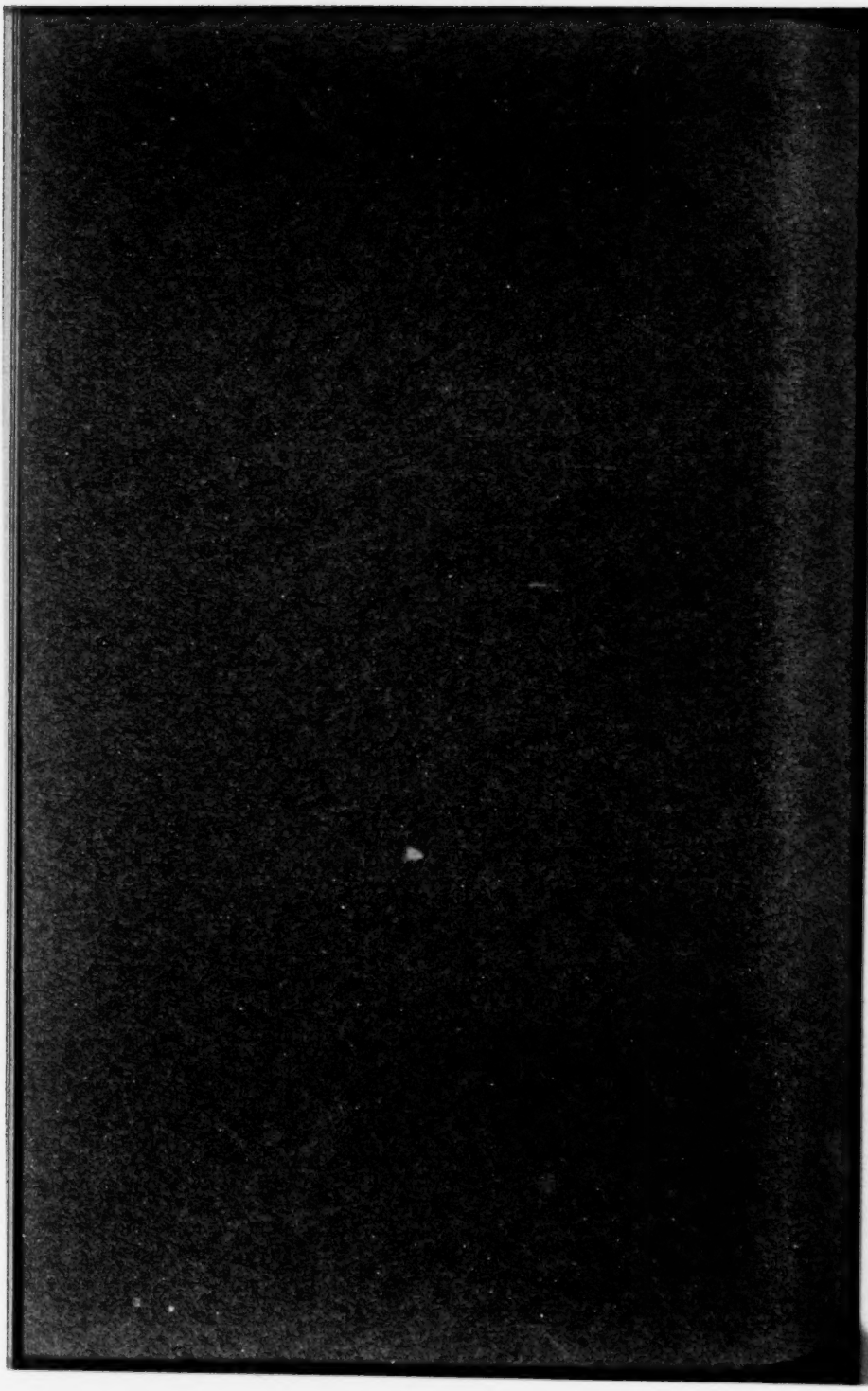

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564362—43

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 500

HENRY BAKER, PETITIONER

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 114a–128a) is reported in 48 F. Supp. 67. The opinion of the Circuit Court of Appeals is not yet reported (R. 133–137).

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 2, 1943 (R. 138). The petition for a writ of certiorari was filed on November 23, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a bankruptcy court has power to set aside certificates of discharge of federal tax liens, issued by the Commissioner of Internal Revenue pursuant to Section 3674 (b), Internal Revenue Code, where the discharges of the tax liens were fraudulently obtained by a judgment creditor holding a junior lien upon the property.

STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra*, pp. 9–14.

STATEMENT

The relevant facts as found by the District Court may be summarized as follows:

On August 12, 1933, the Commissioner of Internal Revenue assessed federal income taxes against James K. Bowen in the amount of $21,181.21. In May 1935 an assessment was made against Bowen for federal distilled spirits taxes in the amount of $13,108.92. Notices of tax liens were duly filed within a few days of each assessment pursuant to Section 3186, Revised Statutes, as amended by the Revenue Act of 1928, Section 613 (a) (now Internal Revenue Code, Section 3672). (R. 115a–116a.) Subsequently in September 1935, Henry Baker, petitioner herein, obtained a judgment against Bowen in the Court of Common Pleas, Lehigh County, Pennsylvania, for $79,240.42. Since the judgment was obtained sub-

sequent to the filing of notices of liens it was, of course, inferior to the federal liens. (R. 116a.)

Bowen's principal asset was the ground and building located on Hamilton Street, Allentown, Pennsylvania. His other properties were mortgaged for more than their value. (R. 116a.) In December 1938, pursuant to Section 3674 (b), Internal Revenue Code, Baker filed an application for a discharge of the liens from the Hamilton Street property. On March 10, 1939, following an investigation the Commissioner authorized the Collector of Internal Revenue to issue certificates of discharge of the liens from the property upon payment of $150. The certificates were issued and filed of record on April 14, 1939. (R. 116a–117a.)

On November 8, 1939, Bowen filed a voluntary petition in bankruptcy. In August 1940 the bankruptcy trustee sold the Hamilton Street property at public sale for $457,500, less broker's commission. (R. 117a–118a.) The United States filed a petition with the referee alleging *inter alia* that the Commissioner had been misled by Baker as to the value of the property and the amounts of indebtedness on various prior judgment liens (R. 7a–15a). The petition prayed that the referee find that the federal liens were proper charges against the proceeds from the sale of the property and were prior to Baker's judgment (R. 15a). After an answer was filed by Baker there was a hearing before the referee, who allowed the Government's tax claims and set aside the discharge

of the federal tax liens, reinstated them and impressed them on the funds in the hands of the trustee, in accordance with a schedule of distribution which gave the Government priority over Baker as to the latter's judgment. (Referee's opinion, R. 68a–104a; Referee's orders, R. 64a–67a; Schedule of Distribution, R. 105a–108a.)

The referee found that the Commissioner was misled by false representations and omissions of material facts by Baker, which induced the Commissioner to authorize the issuance of certificates of discharge and which amounted to constructive fraud (R. 92a). Upon a petition for review filed by Baker, the District Court reversed the referee on the ground that the bankruptcy court had no jurisdiction to vacate or set aside the discharge of federal tax liens. The District Court did not pass on the merits.[1]

On appeal the Circuit Court of Appeals reversed and held (1) that Section 3675, Internal Revenue Code, which provides that "A certificate of release or of partial discharge issued under this subchapter shall be held conclusive that the lien upon the property covered by the certificate is extinguished" does not bar relief to the Government

[1] In addition to contending he had made no misrepresentations in his application, Baker contended the income tax claim was barred by the statute of limitations and not filed within the time fixed by Section 57 (n), Bankruptcy Act. The referee found against all of Baker's contentions (R. 91a). The District Court did not pass on any of these questions.

in the courts where the discharge of the lien was secured through fraud; and (2) that the bankruptcy court had the power to grant the relief sought by the Government.

ARGUMENT

Petitioner urges that under Section 3675, Internal Revenue Code (Appendix, *infra,* p. 14), the certificate of discharge of the lien is conclusive, and that the Government may not invoke the familiar rule enabling an injured party to avoid a transaction because of fraud. We submit that this contention is unsound and that Congress did not intend to render inapplicable the well-established equitable principles under which a transaction may be set aside for fraud. The bankruptcy court certainly has the power to scrutinize the equities of claims filed in the proceedings and to subordinate or disallow claims of creditors who by their frauds secured an inequitable position over other creditors. *Pepper* v. *Litton,* 308 U. S. 295; *Taylor* v. *Standard Gas Co.,* 306 U. S. 307; *American Ins. Co.* v. *Avon Park,* 311 U. S. 138, 146; *Sampsell* v. *Imperial Paper Corp.,* 313 U. S. 215. In *Pepper* v. *Litton, supra,* a dominant stockholder obtained a fraudulent judgment against a corporation for the purpose of defeating claims of creditors. He perfected his judgment lien more than four months prior to bankruptcy of the corporation and the state courts, upon application of the injured creditor, refused to set

aside the judgment. By reason of his judgment lien, the stockholder would have nominal priority over other creditors of the bankrupt corporation in the bankruptcy proceedings. This Court held that the bankruptcy court, under its broad equitable powers, and because of the fraud, properly subordinated the stockholder's judgment lien to claims of other creditors. As this Court stated in *Sampsell* v. *Imperial Paper Corp., supra* (p. 219):

> The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete.

Here, the bankruptcy referee in granting relief applied the same equitable principles as those used in the cases cited above. Equitable relief was awarded the Government by setting aside and vacating the certificates of discharge which had been secured through fraud, thereby giving the claims of the Government lien status and priority over petitioner as to the fund involved. Since no other creditors claimed any interest in the fund, only petitioner was affected by the relief granted. The result reached was the same as if the bankruptcy court had subordinated petitioner's claim to the tax claims of the United States by refusing to give lien status to petitioner's claim, in which event petitioner's claim would have been inferior to the tax claims of the United States even if they were not supported by liens, because of the provi-

sions of Section 64a (4), Bankruptcy Act, as amended (Appendix, *infra,* p. 11).

The bankruptcy court was the only tribunal in which the Government could secure adequate relief. The property had been sold by the trustee under order of the bankruptcy court and the trustee had possession of the proceeds of the sale. It was necessary for the bankruptcy court to determine the order of priority of claims filed in the proceedings, and to do so the validity of lien rights necessarily had to be passed on by the court. Section 2a (7), Bankruptcy Act, as amended (Appendix, *infra,* pp. 9–10); *Straton* v. *New,* 283 U. S. 318, 321; *Ray* v. *Norseworthy,* 23 Wall. 128.

Petitioner relies on *Arkansas Comm'n* v. *Thompson,* 313 U. S. 132. There, it was held that a bankruptcy court had no power to review an order of a state commission which had fixed the value of corporate property for state tax purposes, after hearing evidence as provided by the Act and where no appeal had been taken to the courts, although one was provided for by law. The power of the bankruptcy court to determine the amount and legality of taxes does not carry with it the power to revise property values fixed by the quasi judicial body pursuant to state law. The Act did not intend to give the taxpayer the privilege of two trials, in the state court and the federal court on an indentical issue of fact. There was no question of fraud involved and it was not

contended there was any irregularity in the proceedings before the Commission.

That case is therefore plainly distinguishable. Here, there was no attempt to retry a case in the bankruptcy court, after it had been heard and determined by another tribunal. The Government merely invoked the equitable powers of the bankruptcy court to grant relief on the ground that it had given up valuable lien rights, because of petitioner's fraud. The cases cited in petitioner's brief (p. 12) all involve different questions from the question here presented. None of these cases were concerned with the power of a bankruptcy court or court of equity to grant relief on the ground of fraud or other inequitable conduct, nor did any of them construe the provisions of Section 3675, Internal Revenue Code.

CONCLUSION

The decision of the lower court is correct and not in conflict with other decisions. The petition should be denied.

Respectfully submitted.

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